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In the Supreme Court of the United States

OCTOBER TERM, 1978

DONALD L. MAINS, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
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Washington, D.C. 20530

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The question in this federal income tax case is whether certain corporate distributions made to the shareholders after the assets of the corporations were sold should be taxed as ordinary income or capital gains.

The pertinent facts are as follows: Petitioners were shareholders of two corporations—Gooding Amusement Company, Inc. and Thrills Unlimited, Inc. On April 5, 1966, the two corporations entered into plans of complete liquidation pursuant to Section 337 of the

Internal Revenue Code of 1954.[1] On April 6, 1966, pursuant to the plans, Gooding sold an aggregation of equipment contract rights and goodwill known as "Goodings Million Dollar Midway" or the "Southern Route" for $350,000; Thrills sold a ride known as the "Mad Mouse" to the same purchaser for $25,000. The sales proceeds were distributed pro rata to the shareholders of the two corporations. Both corporations had earnings and profits exceeding the amounts of the distributions (Pet. App. 18-19).

The Southern Route was the largest of ten carnival operating units run by Gooding. The Southern Route played larger fairs than the other units but operated for fewer days and operated primarily in the South rather than the Midwest, as the other units did. The Southern Route accounted for 38.65% of Gooding's revenues and 47.91% of its expenses (Pet. App. 16-17). Thus, the smaller Midwest units were more profitable on a percentage of receipts basis, but the Southern Route earned more than any other route (Pet. App. 17, 26, 34).

Subsequent to April, 1966, Gooding and Thrills abandoned their plans of complete liquidation; on

[1] Under Section 337, if a corporation completely liquidates within twelve months of the adoption of the plan of complete liquidation, no gain or loss is recognized by the corporation on the sale of its assets. If the proceeds of sale are distributed to the shareholders in either a partial liquidation qualifying under Section 346 or a complete liquidation, Section 331 provides that the shareholders recognize capital gain or loss measured by the difference between the value of their distribution and the basis in their stock.

March 24, 1967, they formally amended their plans of liquidation to plans of partial liquidation. On their 1966 tax returns, petitioners took the position that the amounts distributed were payments in partial liquidation of the corporations and, therefore, were taxable at capital gains rates. On audit, the Commissioner of Internal Revenue determined that the transactions were not partial distributions and that the distributions were taxable as ordinary dividend income (Pet. App. 15).

In this refund suit brought by petitioners in the United States District Court for the Southern District of Ohio, the district court held that the sales of assets by both Gooding and Thrills were not partial liquidations under Section 346(a)(2) or (b). It therefore concluded that the distributions received by petitioners were properly taxed as ordinary income (Pet. App. 32).

The court of appeals affirmed as to the district court's holding with respect to Section 346(a)(2) and (b). However, it reversed and remanded the case for a new trial to consider petitioners' claim that the transactions were partial liquidations under Section 346(a)(1), *i.e.*, one of a series of distributions in redemption of all of the stock of the corporations pursuant to a plan (Pet. App. 33-48).

1. The court of appeals correctly held that the distributions by Gooding and Thrills to petitioners were not made pursuant to partial liquidation under Section 346(a)(2) and (b) of the Code. As the court of appeals noted (Pet. App. 37), Section 346

(a)(2) of the Code includes within the definition of partial liquidation those distributions that are not "essentially equivalent to a dividend." The legislative history establishes that qualification under this subsection depends primarily on the existence of a bona fide corporate contraction. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A112 (1954). Here, however, there was no such contraction by either Gooding or Thrills. Although both corporations sold some of their assets, the district court found that in the year following the sale they purchased additional assets having values in excess of the assets sold. The court of appeals therefore concluded that "[c]onsidering the increased purchase of equipment and the relatively small fraction of the assets disposed of, the District Court's finding that there was not a contraction is supported by substantial evidence, and is not clearly erroneous" (Pet. App. 40).

Petitioners argue (Pet. 7-10) that the court of appeals erred in refusing to uphold their claim that the distributions were "one of a series of distributions in redemption of all of the stock of the corporation[s] pursuant to a plan" so as to qualify as a partial liquidation under Section 346(a)(1). In petitioners' view, the fact that the corporations entered into plans of complete liquidation in April 1966 is dispositive of the matter because the distributions at issue were made in 1966. Petitioners urge that the annual method of accounting renders irrelevant the fact that the plans were subsequently abandoned during the following year.

But the decisions of this Court establish that the annual method of accounting does not foreclose consideration of events occurring outside the taxable year in determining the tax consequences of distributions or payments. Cf. *Arrowsmith* v. *Commissioner*, 344 U.S. 6 (1952); *United States* v. *Skelly Oil*, 394 U.S. 678 (1969). Indeed, if petitioners were correct that the 1967 abandonment of the plans of liquidation was irrelevant, it would be a relatively simple matter for shareholders to achieve capital gains by having their corporation adopt a plan of complete liquidation, sell some assets and distribute the proceeds, and then abandon the plan during the following year. *Maguire* v. *Commissioner*, 222 F.2d 472 (7th Cir. 1955), upon which petitioners rely (Pet. 8-9), is not to the contrary. There, the court took into account events occurring after the close of the taxable year and found "a persistent and uninterrupted intention to pursue the plan to final liquidation" (222 F.2d at 479). Hence, *Maguire* is entirely consistent with the decision below.

2. Petitioners further contend (Pet. 10-11) that the court of appeals erred in defining a corporate contraction only in terms of percentage reduction in net worth. But the court did not so hold. To the contrary, the court suggested that there was no corporate contraction at all because both Gooding and Thrills had replaced the equipment that they sold. In the three years immediately following the sale of the Mad Mouse for $25,000, Thrills purchased $149,000 of new equipment, and in the year of sale, Gooding pur-

chased new equipment at a cost in excess of the book value of all the equipment that it sold (Pet. App. 39). Further, the court noted (Pet. App. 40) that "[t]he relative percentage of the assets sold to the entire net worth of the corporations is only one factor to be considered" and that a determination as to the existence of a corporate contraction must be made on the facts of each case. Thus, the court of appeals did not measure corporate contractions solely in terms of percentage reduction in net worth.

3. Finally, petitioners argue (Pet. 11-13) that the court of appeals applied an improper legal standard in determining that Gooding's Southern Route was not a separate trade or business. If the Southern Route was a separate trade or business, then its sale and the payment of the proceeds to the shareholders would have qualified as a partial liquidation ("termination of a business") under Section 346(b).

Both courts below correctly determined that the Southern Route was not a separate trade or business because (1) it was not a viable, separate entity, which included every operation necessary to deliver the service and earn income; and (2) it had no separate supervision and control (Pet. App. 29-30, 42-43). Petitioners err in asserting (Pet. 12) that the decision below held that "almost any degree of participation in or control of non day-to-day * * * business operations by general management is sufficient to defeat any portion of a corporation's business activity from being considered a separate 'trade or business.'" Here, the court of appeals affirmed the district court's finding that Gooding did not conduct two separate businesses, because most management, administration and storage activities were performed as one integrated function, by the same personnel at the same location, except for such activities as could practicably be performed only separately by the Southern Route manager while on tour.

This aspect of the decision below conforms to the definition of "trade or business" provided in Treasury Regulations, Section 1.355-1(c) (26 C.F.R.), as incorporated by Treasury Regulations, Section 1.346-1(c)(2) (see Pet. App. 41). Accord: *Blaschka* v. *United States*, 393 F.2d 983 (Ct. Cl. 1968). While petitioners correctly point out (Pet. 12) that there has been some judicial criticism of Section 1.355-1(c) of the Regulations,[2] those observations were directed solely at Section 355 and not Section 346(b). The latter provision, at issue here, envisions the existence of two separate businesses. Moreover, the legislative history of Section 346 is equally clear as to the necessity of two separate businesses. See S. Rep. No. 1622, 83d Cong., 2d Sess. 262 (1954).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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[2] See *King* v. *Commissioner*, 458 F.2d 245 (6th Cir. 1972); *Rafferty* v. *Commissioner*, 452 F.2d 767 (1st Cir. 1971).

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